Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:NJD:NEW:TL-N-667-99
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date: APR 27 1999

to: Chief, Examination Division, New Jersey District

from: District Counsel, New Jersey District, Newark

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subject: Windfall Tax - [redacted]
U.I.L.# 901.01-03; 901.01-05

This responds to your request for advice on whether a "windfall profits tax" in [redacted] qualifies as an income tax for foreign tax credit purposes. This advice is based on the facts provided by the revenue agent. Since this is a fact sensitive analysis, any additional facts may affect conclusions reached in this memorandum.

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FACTS:

Prior to 1990, the state-owned [redacted] controlled [redacted] in [redacted]. [redacted] On [redacted],

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[redacted] ("government") began to privatize the state-owned [redacted] monopoly. Id. The industry was reorganized to achieve four primary functions: 1) generation; 2) transmission; 3) distribution; and 4) supply. Id. [redacted] ("[redacted]") were established to distribute [redacted] within designated areas. Id. The [redacted] held supply licenses for operating in their local distribution networks. Id. Government regulations provided that customers with a demand for [redacted] of [redacted] or less were required to purchase [redacted] from the [redacted] servicing their area. Id. The limit was lowered to [redacted] in [redacted] and was to be removed altogether by [redacted]. Id. On [redacted], there was an initial public offering of the [redacted]. Id. The government retained a majority interest in the [redacted], thereby preserving control of the [redacted] during the "initial privatization period" ([redacted] to [redacted]). Id. at 134. The government's retained control was referred to as a "golden share" of the [redacted]. Id. After the expiration of the "golden share", [redacted] companies began to takeover the [redacted]. Id. at 135. A total of [redacted] takeovers by [redacted] companies occurred between [redacted] and [redacted]. Id. at 143. On [redacted], [redacted] and [redacted] jointly purchased an [redacted]% interest in [redacted] ([redacted]% ownership by [redacted] and [redacted]% by [redacted]). Id.

A one-time "windfall profits tax" ("windfall levy") was enacted by the government shortly after the election of the [redacted] in [redacted]. Id. at 138. The levy was imposed on the "excess profits" of privatized utilities. Id. The government imposed the levy because it believed that the [redacted] were sold "too cheaply" when the industry was privatized. Id. at 136. The levy was payable in [redacted] installments on or before [redacted] and [redacted]. Id. at 138. The windfall levy was computed at a rate of [redacted] percent on the difference between 1) a company's value at the time it was initially floated ([redacted] for the [redacted]), and 2) an estimate of the company's value over the initial regulatory period. Id. The value at the time of the initial offering was calculated by multiplying the institutional share price by the number of shares initially issued. Id. The estimate of the company's value over the initial regulatory period was calculated by multiplying annual after-tax profits (averaged over the first [redacted] years following flotation, ending before [redacted]) by a P/E ratio of nine. Id. A P/E ratio of nine approximates the lowest average P/E of taxpaying companies during the period. Id. The levy is not deductible in computing the company's [redacted] corporate tax. Id.

ISSUE: Whether [redacted] is entitled to a foreign tax credit for the windfall levy imposed on [redacted]?

CONCLUSION: No.

RULE:

To qualify for a foreign tax credit, a levy paid: 1)must be a "tax"; 2) be paid or accrued to a foreign country or U.S. possession; and 3a) the tax must be an income, war profits or excess profits tax or 3b) must be paid in lieu of such a tax. Treas. Reg. 1.901-2(a). The determination of whether a levy qualifies for a foreign tax credit is made under U.S. income tax principles. Treas. Reg. 1.901-2(a)(2)(i); Keasbey & Mattison Company v. Commissioner, 133 F.2d 894 (3rd Cir. 1943).

1. The levy must be a "tax".

A foreign levy is a tax if it is imposed pursuant to the authority of a foreign country to levy taxes. Treas. Reg. 1.901-2(a)(2)(i). The levy must be imposed by the government in its role as revenue raiser and not in its role as government regulator. Under U.S. income tax principles, a levy is not a "tax" if paid to the government in compensation for some privilege or franchise right. See Rev. Rul. 71-49, 1971-1 C.B. 103; Rev. Rul. 61-152, 1961 C.B. 42; Rev. Rul. 77-29, 1977-1 C.B. 44. Levies imposed on subjects other than income, e.g., franchises, privileges, etc, are not income taxes, although measured on the basis of income. Keasbey & Mattison Company v. Commissioner, 133 F.2d 894 (3rd Cir. 1943).

The Treasury Regulations specify that a payment to a foreign country is not a tax to the extent that the payor receives, or will receive, a "specific economic benefit" in exchange for the payment. Treas. Reg. 1.901-2(a)(2)(i). "Specific economic benefit" means an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed. Treas. Reg. 1.901-2(a)(2)(ii)(B). "Economic benefit includes property; a service; a fee or other payment; a right to use, acquire, or extract resources, patents or other property that a foreign country owns or controls...". Treas. Reg. 1.901-2(a)(2)(ii)(B). "A foreign country controls property that it does not own if the country exhibits substantial indicia of ownership with respect to the property" (Such as exercising regulatory authority). Treas. Reg. 1.901-2(a)(2)(ii)(D). "Economic benefit" does not include the right to engage in business generally or in a particular form. This provision is consistent with rulings and case law under I.R.C. Section 164 which hold that fees paid for incorporation under state law, fees for filing certificates to increase the capital stock of a corporation and fees paid for the privilege to do business in a particular state are all deductible as taxes paid. Rev. Rul. 72-47, 1972-1 C.B. 51; Rev. Rul. 66-184, 1966-2 C.B.; Wayne Coal Mining Co. v. Commissioner, 209 F.2d 152 (3rd Cir. 1954).

A person that is subject to a levy by a foreign country, U.S. possession, or a political subdivision and receives, or will receive, directly or indirectly, a specific economic benefit from the country or possession is defined as a "dual capacity taxpayer". Treas. Reg. 1.901-2(a)(2)(ii)(A). If the application of a foreign levy is different for "dual capacity taxpayers" from its application to other persons, either because of the levy's terms or in practice, the levy as applicable to the dual capacity taxpayers is a separate levy from that imposed on other persons and must be analyzed separately to determine whether it is an income tax. Treas. Reg. 1.901-2A(a)(1). In such a case, the dual capacity taxpayer has the burden of establishing the amount of the levy that is a "tax". Treas. Reg. 1.901-2A(b)(1), 1.901-2A(c)(1). Only one of two methods may be used to establish the portion of a levy which is a "tax": 1) the "facts and circumstances" method and 2) the "safe harbor" method. Treas. Reg. 1.901-2A(b)(1); -2A(c)(1). If a dual capacity taxpayer establishes that a portion of a foreign levy is a "tax", the regulations treat the balance as paid in exchange for the specific economic benefit. Treas. Reg. 1.901-2A(b)(1). Under the facts and circumstances method, a taxpayer must establish the amount of a foreign levy that is not paid in exchange for a specific economic benefit based on "all the relevant facts and circumstances". Treas. reg. 1.901-2A(c)(2)(i). A taxpayer must make an election to utilize the "safe harbor method" to establish the portion of a levy which is a tax. Treas. Reg. 1.901-2A(d)(1). The purpose of the method is to provide a foreign tax credit for an amount approximating the amount of the generally imposed income tax that would have been paid if the taxpayer had not been a dual capacity taxpayer and if the amount considered to be paid for the specific economic benefit had been deductible for foreign income tax purposes. Treas. Reg. 1.901-2A(e)(1). The safe harbor formula is provided in Treas. Reg. 1.901-2A(e)(1).

LEGAL ARGUMENTS:

1) The "excess windfall profits levy" was not imposed pursuant to [redacted]'s authority to levy taxes.

The rationale for imposing the windfall levy was that the government believed the [redacted] were sold "too cheaply". [redacted]. The levy acted as a purchase price adjustment on the sale of [redacted] to [redacted]. Considering the purpose of the tax, it appears that the levy was not imposed pursuant to the government's power to levy taxes. Instead, the levy was imposed by the government as a seller of [redacted]. Therefore, the windfall levy does not qualify as a tax under Treas. Reg. 1.901-2(a)(2)(i).

2) The "excess profits windfall levy" was paid in exchange for a specific economic benefit.

The windfall levy was a compulsory levy imposed on all the [redacted] in [redacted]. In return for the payment of the levy, the [redacted] received: 1) the right to supply [redacted] generally throughout [redacted] and 2) the right to be the sole supplier of [redacted], until [redacted], to customers within their supply region who purchase less than [redacted] of [redacted]. The [redacted] supply industry has historically been owned and controlled by the government. The government relinquished its ownership of the industry beginning in [redacted]. However, it has retained its regulatory power over the industry. As such, the right to supply [redacted] in [redacted] constitutes an "economic benefit" received from the government under Treas. Reg. 1.901-2(a)(2)(ii)(B). In addition, the monopoly over the customers within their service area who purchase less than [redacted] of [redacted] creates a competitive advantage for the [redacted]. The competitive advantage assures the "economic benefit" of a customer base beyond [redacted].

The right to supply [redacted] in [redacted] generally, and the right to be the exclusive supplier within the particular region are not economic benefits which are made available to other persons who are subject to the generally imposed corporate income tax. Therefore, the right constitutes a "specific economic benefit" under Treas. Reg. 1.901-2(a)(2)(ii)(B). Since the [redacted] receive a specific economic benefit in return for the windfall levy, they are "dual capacity taxpayers" under Treas. Reg. 1.901-2(a)(2)(ii)(A). Since the windfall levy is imposed only on the [redacted], it is apparent that its "application for dual capacity taxpayers is different from its application to other persons". As such, the [redacted], under Treas. Reg. 1.901-2A(b)(1), have the burden of establishing what portion, if any, of the windfall levy is not paid in exchange for the specific economic benefit.

The Tax Court in Phillips Petroleum Company v. Commissioner, 104 T.C. 256 (1995), held that a levy imposed by the Norwegian government only on petroleum producers was not paid in return for a specific economic benefit and qualified for a foreign tax credit. The facts in Phillips Petroleum and our facts are similar in that the levies in question were imposed subsequent to the governments conveying the rights to engage in the respective industries. In Phillips Petroleum, the court based its holding, in part, on the fact that "no new benefit" was received through the payment of the levy. Id. 290. The court emphasized that the government was adequately compensated for the right to exploit minerals through the payment of other royalties and fees. Id. 293. Therefore, the additional levy was not paid in return for the specific economic benefit of exploiting minerals.

Our facts are distinguishable from those in Phillips Petroleum. The government imposed the windfall levy because the utilities were sold at a discounted price. Unlike in Phillips Petroleum, the windfall levy was imposed because the government was not adequately compensated for the right to supply [redacted] in [redacted]. Therefore, the windfall levy was part of the "levy" paid in return for the specific economic benefit of supplying [redacted] in [redacted]. In Phillips Petroleum, the court stated that, "Norway's purpose behind the enactment of the [levy] was in fact to take advantage of a new profit situation created by surging oil prices, and to receive a larger share of what Norway saw as extraordinarily high and unforseen profits...". Id. 292. In contrast, the government's purpose behind the enactment of the windfall levy was to properly adjust upward the initial sales price. Based on the initial discounted price of the [redacted], it was foreseeable to the [redacted] that additional levies would be imposed as part of the "sales price". Therefore, unlike the levy in Phillips Petroleum, the windfall levy was paid in exchange for a specific economic benefit.[1]

Based upon the above analysis, it appears that the windfall levy does not constitute a "tax". Although the issue of whether the windfall levy is a creditable tax appears to be disposed of under the first prong of the test, we will continue to analyze the levy under the other parts of the test.

2. The tax must be paid to a foreign country.

Under our facts, this requirement is not at issue since it is apparent that the windfall levy is paid to a foreign country.

3a. The tax must have the "predominant character of an income tax in the U.S. sense". Treas. Reg. 1.901-2(a)(1)(ii).

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[1]Philips Petroleum can also be distinguished by the fact that the temporary regulations were controlling in that case. In addition, we were advised by Joan Thomsen and David Bergkuist, National Office International Group, that the Service does not agree with the holding in Phillips Petroleum.

Rule:

Under the regulations, a tax has the "predominant character of an income tax in the U.S. sense" if: i) The tax is "likely to reach net gain"; Treas. Reg. 1.901-2(a)(3)(i); Bank of America National Trust and Savings Association v. United States, 459 F.2d 513 (Claim Ct. 1972); and ii) the tax does not depend on the availability of a credit for the tax against income tax liability to another country (must not be a "soak-up" tax). Treas. Reg. 1.901-2(a)(3)(ii). A tax either is or is not an income tax in its entirety. Treas. Reg. 1.901-2(a)(1)(ii).

i) The tax must be likely to reach net gain.

In Bank of America National Trust and Savings Association, it was held that a foreign levy qualifies as a creditable tax if the foreign country is attempting to reach net gain through the levy. Id. In adopting the principal established in Bank of America National Trust and Savings Association, the regulations provide that a tax is "likely to reach net gain" in the normal circumstances in which it applies if, and only if, the tax, judged on the basis of its predominant character, meets each of the following tests (Treas. Reg. 1.901 -2(b)(1)):

A. Realization Test. In general, a tax satisfies the realization requirement if; judged on the basis of its predominant character, it is imposed upon or subsequent to the occurrence of events that would result in the realization of income under the Internal Revenue Code. Treas. Reg. 1.901-2(b)(2)(i)(A). The regulations provide exceptions to the general rule which provide that certain taxes imposed prior to a "realization event" satisfies the test.

B. Gross Receipts Test. A tax meets the gross receipts requirement if, based on its predominant character, it is imposed either on actual gross receipts or on formulary gross receipts computed under a method that is likely to produce an amount that is not greater that the actual gross receipts. Treas. Reg. 1.901-2(b)(3).

C. Net Income Test. The regulations provide that the foreign tax must permit the recovery of significant costs and expenses attributable, under reasonable principles, to gross receipts included in the foreign tax base. Treas. Reg. 1.901-2(b)(4)(i)(A). The regulations provide specific guidelines in determining whether the structure of the foreign tax permits the recovery of "significant costs and expenses". See Treas. Reg. 1.901-2(b)(4). In regards to formulary taxes, deductions may be computed under a formulary method if that method is likely to produce deductions that approximate the actual amount of deductions. Treas. Reg. 1.901-2(b)(4)(i).

Legal Argument:

The government is not attempting to reach net gain through the windfall levy. The levy is focused on reaching the increase in the value of the [redacted]. The increase in value is determined as follows: [Average profits over the first [redacted] years multiplied by a P/E of 9] minus [institutional share price multiplied by the number of shares initially issued]. The levy equals [redacted]% of such amount. The levy is not imposed on gross receipts or a formulary method that is likely to produce an amount that is not greater than actual gross receipts. See Tres. Reg. 1.901-2(b)(3)(ii), Ex. 3. In addition, the amount subject to the levy does not correspond with the realized net income of the [redacted]. For example, assume the following facts: the average after tax profits of the [redacted] over the initial regulatory period (5yrs.) was $[redacted]. The initial share price was $[redacted] and [redacted] shares were issued. The windfall levy would be imposed on $[redacted] ([redacted] - [redacted]). In comparison, if the levy was imposed on the realized net profits for each year, the amount subject to the tax would be $[redacted] per year for a total of $[redacted].

In the above example the levy would be imposed on an amount which has not been realized into income. The regulations provide that a foreign tax imposed on a pre-realization event satisfies the realization requirement, if: 1) the tax is based on the difference in the value of property at the beginning and end of a period; and 2) the foreign country does not, upon the occurrence of a later event, impose a tax with respect to the income on which tax is imposed by reason of such pre-realization event(unless it provides a credit for the first tax paid). Treas. Reg. 1.901-2(b)(2)(i)(C). In our facts, when, and if, an additional $1,000,000 is realized into income, it would be subject to the general corporate income tax. Therefore, the levy does not satisfy the realization requirement under Treas. Reg. 1.901-2(b)(2)(i)(C). See also F.W. Woolworth Co. v. Commissioner, 54 T.C. 1233 (1970)(A tax on imputed rental value is not an income tax since it is not based upon gain or profit realized by the taxpayer).

Although the realized net profits are part of the windfall levy calculation, the levy, based on its "predominant character", was focused on reaching the increased value of the [redacted] and not realized net income. As such, the windfall levy does not qualify as an income tax. See Treas. Reg. 1.901-2(b)(2)(i)(C)(2)(Flush Language). In the event that the [redacted] is not profitable in the future, there is no provision which allows recovery of the windfall levy. As such, it can not be said that the levy is likely to reach net gain. See Bank of America National Trust and Savings Association v. United States, 459 F.2d 513, 524 (Claim Ct. 1972). Judged on its predominant character the windfall levy is not an income tax in the U.S. sense.

ii. The levy is not a "soak-up" tax.

Liability for the windfall levy is not contingent on whether they qualify for a foreign tax credit in another country. Therefore, it is not a "soak-up" tax.

3b. A tax paid in lieu of an income tax qualifies for a foreign tax credit.

The term "income, war profits, and excess profits tax" includes a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States. I.R.C. Section 903. A foreign levy is a tax in lieu of an income tax if and only if, i) it is a tax within the meaning of Treas. Reg. 1.901-2(a)(2); and ii) it meets the "substitution requirements". Treas. Reg. 1.903-1(a). It is immaterial whether the base of the foreign tax bears any relation to realized net income. Id. It is also immaterial whether or not the tax was imposed due to administrative difficulty in determining the base of the income tax. Id.

i) Whether the excess profits levy is a tax within the meaning of Treas. Reg. 1.901-2(a)(2) is discussed above.

ii) A foreign tax satisfies the substitution requirement if the following two requirements are met:

1)The tax operates as a tax imposed in substitution for, and not in addition to, an income tax otherwise generally imposed. Treas. Reg. 1.903-1(b)(1).

2) Liability for the foreign tax is not dependent on the availability of a credit for the foreign tax against the income tax liability to another country. Treas. Reg. 1.903-1(b)(2).

The windfall levy is imposed on the increase in value of the [redacted]. When the [redacted] realizes income, it is subject to the corporate income tax in [redacted]. The windfall levy is imposed in addition to the generally imposed corporate income tax and does not qualify as a tax paid in lieu of an income tax under Section 903.

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